

Attachment A

Summary of decisions related to the securitisation framework

Based on comments put forth by the industry in response to CP3, the Committee has made several modifications to the internal ratings-based (IRB) approach to securitisation exposures. The changes follow the decisions of the Committee at its October 2003 meeting in Madrid to address industry concerns raised during consultations related to complexity of the securitisation proposal and potential operational burden related to its implementation. Additionally, industry comments focused on the need for greater internal consistency among the proposals comprising the securitisation framework. A more complete discussion of the Committee's considerations and its proposed revisions to the securitisation framework will be made public shortly.

Treatment of unrated exposures

The Supervisory Formula (SF) described in CP3 was developed to address unrated exposures including those to asset-backed commercial paper (ABCP) conduits. Initial industry reactions to the SF focused on its complexity and associated computational burden. Furthermore, industry participants questioned the consistency of the SF with banks' current risk management practices. After evaluating these comments and conducting additional analysis of its own, the Committee is introducing the following alternatives in lieu of the SF approach contained in CP3, as well as modifications to the calculation of K_{IRB} , which is the capital charge that would have applied had the assets not been securitised.

1. Introduction of an internal assessments approach

The Committee is introducing an internal assessment approach (IAA) for determining capital charges against liquidity facilities and credit enhancements that banks (including third-party banks) extend to ABCP conduits. The IAA would be applicable only to exposures to ABCP conduits that have an internal rating equivalent of investment-grade at inception. It would not be available beyond this limited scope. The IAA will simplify the treatment of banks' exposures to ABCP conduits by aligning regulatory capital requirements more closely to banks' internal risk management practices for such exposures. Subject to a set of operational standards, banks would derive their internal assessments of such exposures based on rating agency criteria for the asset type purchased by the conduit, including those criteria pertaining to the amount of seller-provided credit enhancement needed to achieve a given rating equivalent. The notional amount of the exposure would then be assigned the risk weight corresponding to the external rating equivalent under the Ratings-Based Approach (RBA).

2. Simplification of the Supervisory Formula

In addition to introducing the IAA, the Committee is proposing a simplification to the SF presented in CP3 to be made available to all unrated exposures including liquidity facilities and credit enhancements extended to ABCP conduits. The Simplified SF is based on four bank-supplied inputs: (1) the capital charge that would be applied had the assets not been securitised (K_{IRB} , which, as in CP3, will continue to be defined as the sum of expected and unexpected losses); (2) the degree of credit enhancement supporting a given position (L); (3) the thickness of the exposure in question (T); and (4) the effective number of exposures in the securitised pool (N). In contrast to the SF discussed in CP3, the simplified version would not result in different capital requirements in cases where two pools may have the same K_{IRB} , but different exposure-weighted average LGDs. Accordingly, this eliminates that average as an input to the Simplified SF. In addition, the Simplified SF would be computationally less complex than the formula provided in CP3. It will be elaborated on in the forthcoming technical paper on revisions to the securitisation framework.

Since the publication of the Committee's October 2003 press release regarding its plans to replace the SF with a simpler approach, the Committee has heard from some industry representatives that they would not favour its replacement. The Committee is interested in learning whether such views are widespread.

3. Modifications to Top-Down Approach for calculating K_{IRB}

Market participants raised concerns about their ability to calculate K_{IRB} , an input to all variants of the SF, for securitisation exposures subject to the “top-down” IRB approach outlined in CP3. Banks have indicated that it would be difficult for them to decompose in a reliable manner their expected loss estimates into PD and LGD components. As a result, they would be required under CP3 to assign a LGD of 100% to such exposures. Combined with a conservative treatment of dilution risk, the capital charge associated with the top-down approach was considered to be unduly harsh by the industry.

The Committee is now planning to develop less restrictive operational criteria for allowing banks to rely on their own LGD estimates for securitisation exposures, particularly for exposures to ABCP conduits. The Committee has asked its Securitisation Group to develop more flexible criteria that are broadly consistent with those for the IAA where appropriate. The Committee also recognises that requiring capital for both dilution risk and default risk may represent the double counting of risk. It is working to resolve this issue. These simplifications should help to ensure that banks are able to calculate K_{IRB} for a large number of positions and help to avoid the need for banks to apply more conservative supervisory assumptions to some exposures when determining the capital requirement under the SF.

Consistency within the Securitisation Framework

The Committee has sought to address concerns expressed about the need for greater consistency within the securitisation framework.

1. Simplified SF

The Simplified SF is based on more conservative assumptions than those underlying the formula presented in CP3 in order to bring the analytical models underlying the SF and RBA into closer alignment. As noted above, the Committee recognises the interest of some market participants to retain the original SF. If the original formula were retained, this would by extension raise questions about the need to make modifications similar to those incorporated into the simplified SF to ensure consistency. One such change could involve reductions in the so-called tau parameter found in the formula presented in CP3.

2. Treat originating and investing banks in a similar manner

Additionally, the Committee decided to enhance consistency within the IRB securitisation framework by eliminating differences in the treatment of securitisation exposures held by originators and investors. In CP3, originating banks were required to deduct all positions (whether externally rated or unrated) that fell below the K_{IRB} threshold. Under the change adopted by the Committee, originators would be permitted to recognise external ratings through the equivalent of BB- on positions that fall below the K_{IRB} boundary. The treatment may also be referred to as an “external rating override”. The cap on an originating bank’s maximum capital requirement will remain in place.

As noted, the change described above is meant to respond to comments made by the industry that the risk associated with a given position is not dependent upon the holder of such a position. In making this change, the Committee reaffirms the importance of external ratings as a market signal of the inherent risk of a given securitisation exposure when a position is externally rated or subject to the IAA. The Committee views the change as an important simplification to the IRB securitisation framework.

Treatment of Rated Securitisation Exposures

In response to industry views, the Committee agreed on changes to the RBA to better align those risk weights with the level of risk inherent in securitisation exposures. As noted in CP3, the RBA applies to externally rated positions as well as those where an inferred rating would apply; as a result of the changes, the RBA would also be used for mapping internal assessments under the IAA to capital charges.

1. Greater focus on seniority

The first change is to shift the focus of the exposures eligible for the lowest set of risk weights (found in the left most column of the RBA risk weight tables in CP3) away from the concept of “thickness” toward “seniority.” Commenters have noted that by expanding the eligibility for the preferential risk weights to senior tranches, the RBA framework could be simplified with little or no loss of risk sensitivity. Analyses conducted by the Committee confirm this result. In consequence, this change being made by the Committee would make the lower set of risk weights available to a broader array of exposures.

2. Enhance sensitivity to risk of well-rated exposures

In addition to redefining the definition for applying the column of lower RBA risk weights, the Committee is further differentiating some of the preferential risk weights, as noted below in bold text.

Alternative RBA Risk Weights

External Rating (Illustrative)	Risk weights for senior tranches & eligible IAA	Base risk weights	Risk weights for tranches backed by non-granular pools
Aaa	7%	12%	20%
Aa	8%	15%	25%
A1	10%	18%	35%
A2	12%	20%	
A3	20%	35%	
Baa1	35%	50%	50%
Baa2	60%	75%	75%
Baa3	100%	100%	100%
Ba1	250%	250%	250%
Ba2	425%	425%	425%
Ba3	650%	650%	650%
Below Ba3 and unrated	Deduction	Deduction	Deduction

The Committee also considered the industry request to differentiate RBA risk weights by asset type. After further additional review, it does not believe that such a change would result in a material improvement in risk sensitivity.

Additional Considerations

The Committee recognises that by its very nature securitisation relates to the transfer of ownership and/or risks associated with the credit exposures of a bank to other parties. In this respect, securitisation is important in helping to provide better risk diversification and to enhance financial stability. The securitisation framework and its capital impact for originating banks are premised on

the expectation that securitisation is used to transfer significant levels of credit risk. Supervisors are considering ways to monitor securitisation transactions to ensure that this is the case. As noted in CP3, supervisors will evaluate transactions based on their economic substance as part of their review process to ensure that the capital treatment for securitisation transactions is applied appropriately.